Casualty Practice

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MANAGING GLOBAL PRODUCT LIABILITY RISKS

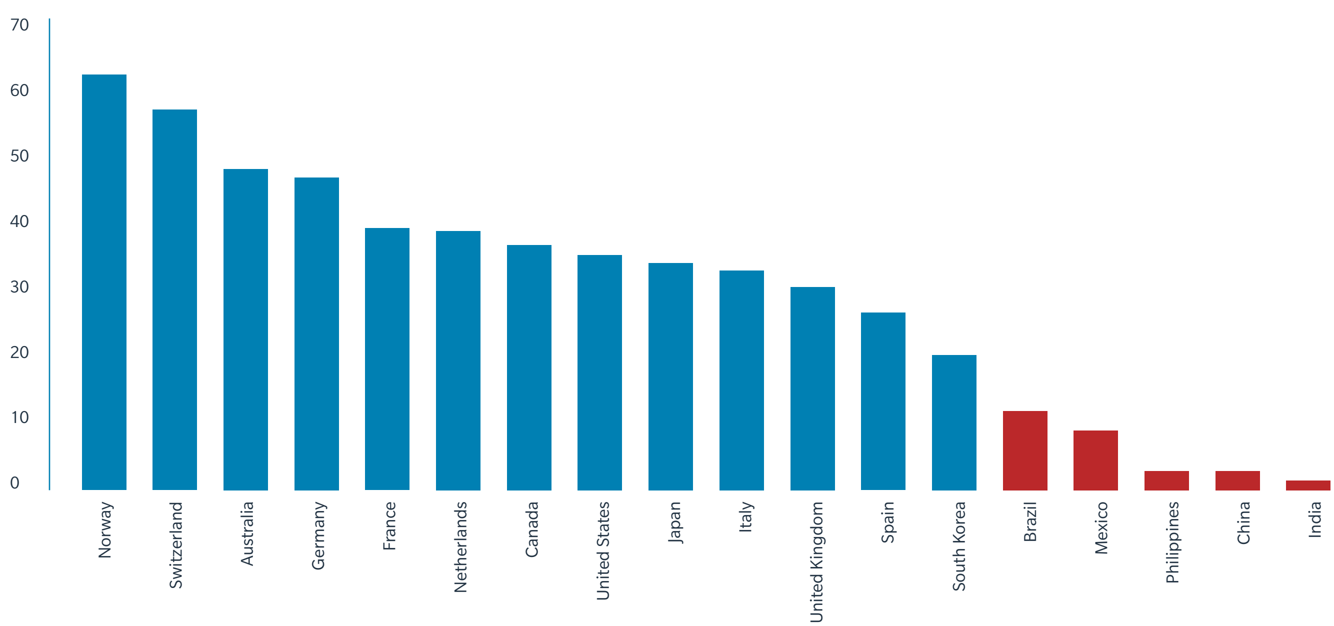
CONTENTS:

Globalization offers opportunities for multinationals to expand into and source from new markets, but it can also present significant operational and regulatory challenges around product liability. Diverse insurance and regulatory requirements — coupled with supply chain challenges — often make managing product liability risk globally more complex. Businesses can face regulatory fines, costly litigation and product recalls, and reputational damage in the event of a product failure or contamination. It's essential that a product liability insurance program considers the interplay of policies and regulations in all countries where an organization operates. And this must work alongside rigorous planning and preparation to help businesses stay compliant and best manage their global product liability risks.

GLOBAL SOURCING

For companies that manufacture or sell tangible products — from automakers and technology firms to life sciences companies and retailers — the equation is simple: The cost of production in emerging markets is far lower than it is in the United States and other developed economies (see Figure 1). Aside from potential savings in production costs, the large populations in developing countries — including Brazil, China, and India — represent an opportunity to reach new consumers.

FIGURE 1: AVERAGE HOURLY MANUFACTURING COMPENSATION COSTS, 2012 (OR NEAREST YEAR), SELECTED COUNTRIES IN US DOLLARS



Source: Bureau of Labor Statistics

But sourcing production globally comes with challenges. Product quality procedures and standards in emerging markets often do not match those found in developed markets, raising potential production issues. The situation is often exacerbated by limited visibility into complex global supply chains, including second- and third-tier suppliers in emerging markets.

COSTLY PRODUCT FAILURES AND CONTAMINATIONS

The challenges associated with globalization can contribute to product failures and contamination incidents. The costs of recalls, litigation, falling stock prices, and damaged reputations can extend into the millions or even billions of dollars and can sometimes put a company out of business. For example:

- A 2010 study conducted by the Grocery Manufacturers Association, Food Marketing Institute, and GS1 estimated that the average recall costs a food company $10 million in direct costs. This includes notification to customers and suppliers and removing/replacing unsafe or damaged products. [1]
- High profile auto safety concerns and recalls over the last several years have cost manufacturers hundreds of millions of dollars in litigation costs and regulatory fines.
- A compounding pharmacy filed for Chapter 11 bankruptcy protection in December 2012 after its products were tied to the meningitis outbreak that killed dozens and injured hundreds. [2]

TIGHTENING REGULATORY ENVIRONMENT

Regulatory scrutiny is also increasing. From 2009 to 2013, the US Consumer Product Safety Commission (CPSC) imposed more than $31 million in civil penalties for corporate violations of product safety standards — many involving foreign suppliers or manufacturers (see Figure 2). Although fewer companies were penalized in 2012 and 2013 compared to the previous three years, the average penalty imposed by the agency steadily increased from $436,000 in 2009 to more than $1.5 million in 2013.

The costs associated with product failures are likely to increase as businesses expand into new markets and regulators strengthen consumer protections globally. For example:

- The US Consumer Product Safety Improvement Act of 2008 increased the maximum penalty that the CPSC can impose for a related series of violations from $1.8 million to $15 million. [3]
- In February 2013, the European Commission proposed reforms of its General Product Safety Directive. Among other changes, the proposal would introduce new product labeling requirements and impose greater regulatory scrutiny in the event of a product contamination or failure. [4]

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1 Grocery Manufacturers Association. Recall Execution Effectiveness: Collaborative Approaches to Improving Consumer Safety and Confidence. Available at http://www.gmaonline.org/downloads/research-and-reports/WP_RecallExecution.pdf

2 “New England Compounding Center Files for Chapter 11 Bankruptcy Protection, Seeks to Establish Fund to Compensate those Affected by Meningitis Outbreak,” available at http://www.businesswire.com/news/home/20121221006045/en/england-compounding-Center-files-chapter-11-bankruptcy.

3 “CPSC Approves Final Rule on Civil Penalty Factors,” available at http://www.cpsc.gov/en/Newsroom/News-Releases/2010/CPSC-Approves-Final-Rule-on-Civil-Penalty-Factors/.

4 European Commission. Product Safety and Market Surveillance Package: Proposal for a Regulation of the European Parliament and of the Council on Consumer Product Safety and Repealing Council Directive 87/357/EEC and Directive 2001/95/EC. Available at http://ec.europa.eu/consumers/safety/psmsp/docs/psmsp-act_en.pdf

Global Insurance and Tax Requirements

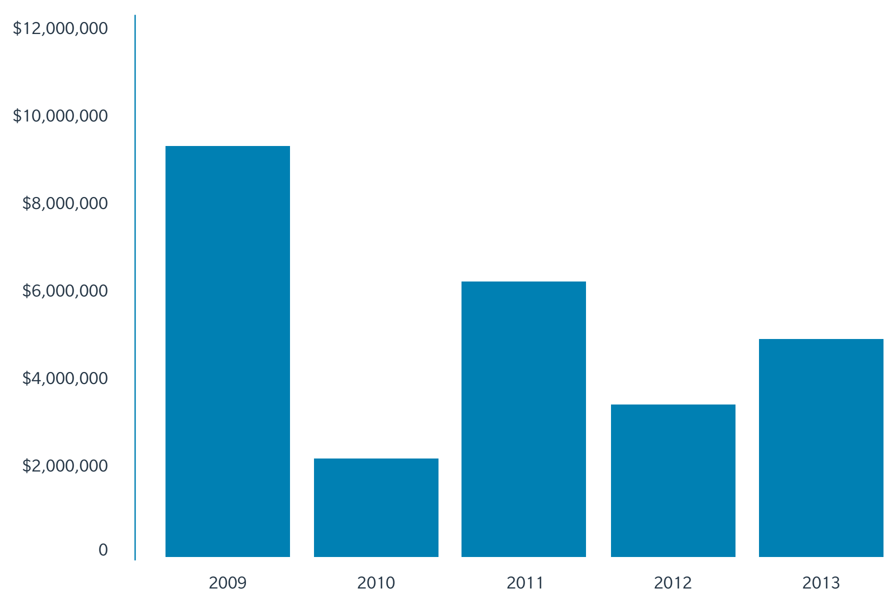
Building an effective global insurance program requires multinationals to navigate diverse and sometimes conflicting insurance and tax requirements. Areas where these requirements can vary include:

- **Admitted vs. non-admitted insurance:** Insurance regulators are often protective of local insurance marketplaces. In most countries — particularly developing markets — this means that businesses can only purchase insurance from locally licensed insurers.
- **Income tax considerations:** Claims payment under non-admitted insurance may be subject to double income taxation, both in the country where claim proceeds are received (if different from the country where the claim arises) and upon repatriation of funds to the loss bearing entity. Failing to understand these income tax implications can result in lower net recoveries.
- **Compulsory insurance coverage:** Certain lines of coverage are required in various countries. Determining the appropriate local policy choices requires an understanding of statutes and customs by country and both local and global market conditions.

- In October 2013, China introduced new consumer protection laws that increase corporate fines for product failures leading to injuries by consumers. [5]
- In November 2013, the CPSC proposed a rule that would make legally binding the voluntary recall agreements that it negotiates with companies. This could open manufacturers, retailers, and others to new litigation from the CPSC. [6]

Regulators have also demonstrated a commitment to enforcing rules and requirements governing insurance programs and tax structures (see sidebar). Tax laws, in particular, present a relatively easy way for governments to raise revenue. Canada, Australia, Germany, the Netherlands, and the US have bolstered audit and enforcement activities to collect the premium taxes they are due.

FIGURE 2: CIVIL PENALTIES IMPOSED BY US CONSUMER PRODUCT SAFETY COMMISSION, 2009 TO 2013



Source: Consumer Product Safety Commission

5 "Amendments to Consumer Protection Law Allows for Public Interest Lawsuits With Limitations," available at http://www.cecc.gov/publications/commission-analysis/amendments-to-consumer-protection-law-allows-for-public-interest.

6 "Joint Statement of Chairman Tenenbaum, Commissioner Adler and Commissioner Robinson on the Notice of Proposed Rulemaking Regarding Voluntary Recall Notices and Corrective Action Plans," available at http://www.cpsc.gov/en/About-CPSC/Chairman/Statements/Joint-Statement-of-Chairman-Tenenbaum-Commissioner-Adler-and-Commissioner-Robinson-on-the-Notice-of-Proposed-Rulemaking-Regarding-Voluntary-Recall-Notices-and-Corrective-Action-Plans/

INDUSTRY CHALLENGES

Some industries have unique challenges that can affect product liability risk management. For example:

- Life sciences companies that want to conduct clinical trials in various countries must produce insurance certificates required by local ethics committees. Failure to produce such certificates — often required to be issued in local languages by locally admitted insurers — in a timely manner can lead to delays in trials and other operational challenges.

- Auto manufacturers and some large retailers often require foreign suppliers to purchase product recall insurance as part of their contractual agreements. Obligations can vary by country; German auto manufacturers, for example, are known for imposing particularly strict requirements. Suppliers that are not willing to purchase such coverage could risk losing valuable business.

BUILDING AN EFFECTIVE PRODUCT LIABILITY INSURANCE PROGRAM

This complex risk landscape underscores the importance of having an effective insurance program to address global product liability risks. When structuring a global insurance program, multinationals need to carefully consider a number of factors beyond whether to purchase insurance on an admitted or non-admitted basis. For example, businesses should review the need for local claims support and other expertise; the tax implications of claims payments and premium allocations for subsidiaries; cash before cover requirements and other terms of premium payments; and other nuances in local conditions.

A multinational company can consider several global insurance program structures, including:

- A controlled master program (CMP). This is a uniform program typically placed with a single global lead insurer.

- A series of non-centralized policies purchased locally in each country where the business operates. Such policies would be issued by locally admitted insurers and tailored to the regulatory requirements of each country.

- A single global policy with no locally admitted policies. While this approach yields cost savings and makes program administration simpler, it can present regulatory and tax risks, claims uncertainty, and the inability to provide evidence of insurance in most countries.

- **Insurance premium taxes:** Even in countries where non-admitted insurance is allowed, a local company relying on non-admitted insurance will most likely be responsible for addressing insurance premium-related taxes. This obligation exists even if the parent company does not internally recharge premiums to foreign operations.

- **Local liability limits:** Many businesses are purchasing higher liability limits in the countries where they operate to improve the effectiveness of their programs. In the event of a large loss, a higher liability limit can result in more efficient claims handling and tax management, and generally help organizations to stay compliant with local regulations.

- **Proof of insurance:** Customers, landlords, ethics committees, and other stakeholders often require US companies to provide evidence of their insurance coverage for operations in other countries. These companies also often seek evidence of insurance from their own suppliers, contractors, and other parties in countries where they may not be familiar with insurance customs, norms, and regulations. Companies often evidence their non-admitted global coverage for operations in countries that do not allow such insurance — resulting in unintentional violations of local admitted insurance regulations.

- **"Cash before cover":** In many countries, coverage will not go into effect until insurance premiums are paid. This requirement can even vary within a country — in China, for example. Failure to comply with cash before cover regulations could lead to a coverage gap and uncovered claims.

CMPs have grown more attractive as regulators have increasingly focused on insurance and tax compliance in recent years. Under a CMP, "local" admitted policies mirror the terms and conditions of a "master" non-admitted policy to the greatest extent possible. The master policy is typically structured as a difference-in-conditions and difference-in-limits contract (DIC/DIL). This means that any differences in conditions or limits between the master and underlying local policies are provided by the global master policy, albeit on a non-admitted basis. Underlying locally admitted policies typically conform to certain local laws, regulations, and customs in the specific country, helping the business stay compliant.

A CMP also gives buyers centralized control of their global insurance portfolios and a mechanism for better communication between all parties, including insurers, brokers, and other risk advisors. Additionally, working with an insurer with a global network may simplify the claims process.

GLOBAL INSURANCE POLICY INVENTORY

Whether they choose a controlled master program or another structure, businesses should understand all of the local insurance policies that may be in place. A thorough inventory of a global program can help risk managers to:

- Understand where each policy stands in its life cycle — including inception and expiration dates — and better ensure consistency in terms and conditions.
- Identify whether a certain type of loss is covered under a local policy or will fall under non-admitted coverage as part of a master policy.
- Notify insurers in the event of a loss.

A detailed insurance policy inventory can also help businesses identify coverage gaps that may need to be addressed. A standard commercial general liability policy may offer protection against bodily injury tied to the failure or contamination of a product. But businesses may also consider other forms of coverage that are available in most countries. For example:

- Product liability insurance, which protects manufacturers and sellers from liability for losses or injuries to consumers or others as a result of a product defect or failure. Coverage could also include design defects or "failure to warn" claims.
- Product recall insurance, which can be customized to provide coverage for business interruption and extra expense, brand rehabilitation, third-party risk, and expenses associated with the execution of a recall.
- Industry-specific solutions -- for example, clinical trials insurance coverage for life sciences companies.

PLANNING AND PREPARATION

Businesses can also manage product risk through effective planning and preparation. This begins with an assessment of product liability risks tied to individual products and geographies and the modeling of potential loss scenarios. This information can be used to develop new strategies — from product design and manufacturing to marketing and product recall planning — to minimize or mitigate liability risk.

Organizations should also seek to better understand their supply chains, including second- and third-tier suppliers. Businesses should proactively investigate all suppliers' quality control and risk management plans and procedures and also consider adding compliance language, indemnification, and financial penalties into their supplier contracts.

Lastly, businesses should be ready to act in the event of a product failure or contamination event. A crisis plan should clearly define roles and processes governing all aspects of a recall. This should include communications — via multiple channels — with customers, regulators, employees, suppliers, and news media. Businesses also should be prepared to trace products and components throughout their supply chain, be ready to execute a recall as necessary, and be able to account for all related costs for claims purposes. Having the right infrastructure in place ahead of time — for example, the ability to launch web sites and staff call centers in multiple languages and a plan to collect unsafe products and redistribute safe products — can help organizations to quickly initiate a recall and recover from it.

A PRODUCT LIABILITY INSURANCE PROGRAM SHOULD CONSIDER THE INTERPLAY OF POLICIES AND REGULATIONS IN ALL COUNTRIES WHERE AN ORGANIZATION OPERATES. THIS MUST WORK ALONGSIDE RIGOROUS PLANNING AND PREPARATION TO HELP BUSINESSES STAY COMPLIANT AND MANAGE THEIR LIABILITY RISKS.

This report was prepared by Marsh's Casualty Practice in conjunction with Marsh's Multinational Client Service, Marsh's Global Insurance Regulatory and Tax Consulting Practice, Marsh's Product Recall Practice, and Marsh Risk Consulting.

Marsh's Casualty Practice develops customized solutions ranging from traditional transactional casualty insurance programs — both primary and excess — to strategic financing and integrated risk programs. Marsh's Casualty Practice is committed to providing comprehensive advice and expert analysis on overall policy construction with industry-leading competitive terms. This can include reducing costs, managing volatility, broadening coverage, streamlining administration, developing cost allocation strategies, managing collateral, providing budgeting information, and more.

For more information, contact:

MICHAEL RODGERS
Marsh
+1 212 345 5255
michael.d.rodgers@marsh.com